Testimony of
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Financing Employee Ownership Programs: An Overview

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Good afternoon and thank you, Mr. Chairman, Congressman Sanders, and other members of this subcommittee, for the opportunity to testify on behalf of the National Cooperative Business Association about the need for federal assistance to spur the start-up and expansion of employee-owned businesses. In particular, I will address the importance of worker cooperatives as employee-owned businesses deserving of incentives from the federal government.

I am Richard Dines and I am Director of Cooperative Business Development and Member Services for the National Cooperative Business Association, or NCBA. NCBA represents cooperatives and cooperative service organizations across all industries including agriculture, food retail and distribution, childcare, energy, finance, housing, insurance, childcare and many others. Our members include producer cooperatives, owned by farmers to process and market their products and to provide themselves with credit, equipment and supplies; consumer cooperatives owned by consumers to obtain products and services at a reasonable price; purchasing cooperatives owned by businesses who band together to enhance their purchasing power and competitiveness; and worker cooperatives owned and governed by the employees of their businesses.

NCBA

NCBA provides a broad range of services to its members in the areas of public policy, business development, and education. NCBA was founded in 1916 as the Cooperative League of the U.S.A. and we have a long and proud history of helping develop cooperative businesses to meet people's needs. After World War II, we were instrumental in founding CARE, the Cooperative for American Relief Everywhere, to address the economic reconstruction of a devastated Europe. In the 1950s and 1960s, we began our work helping to organize cooperatives in the developing world to assist groups of consumers and producers access the marketplace. In the 1970s, we led a national campaign to establish a National Cooperative Bank to meet the credit needs of non-agricultural cooperatives. In the 1980's, we launched an effort to revitalize rural America through a network of cooperative development centers that would provide technical assistance to groups forming new co-ops in rural areas. That effort resulted in the Rural Cooperative Development Grants program at the U.S. Department of Agriculture and a national network of centers called CooperationWorks helps rural cooperatives across the country.

NCBA is now working on an Urban Cooperative Development Initiative. This Initiative is focused on demonstrating the effectiveness of cooperative businesses in meeting the economic needs of urban residents and building wealth and ownership. There are thousands of credit unions, housing co-ops, health care co-ops, child care co-ops, and others already meeting those needs, but both community development organizations and federal economic development policies and programs usually overlook the cooperative business model when devising plans to start new businesses in urban settings. We hope to change that thinking with our Initiative.

The first project of our Initiative will be the development of a worker cooperative serving office cleaners in the Washington, D.C. area. We selected this project because we wanted to demonstrate that a worker-owned cooperative can be a critical and viable tool to create jobs that pay livable wages and offer solid benefits. When the workers own their own business, they ensure that they are compensated fairly and tend to be more productive because it is their business on the line if it does not perform well. Once the worker-owned cleaning cooperative is up and running, we plan to replicate it in other cities and help develop other types of cooperatives serving the same population.

Why Employee Ownership Through Worker Cooperatives?

I am sure that my fellow witnesses will ably make the case that employee ownership makes sense for businesses in the U.S. and that federal assistance to help start and expand employee-owned businesses is in the best interests of the American taxpayer. Dr. Douglas Kruse with Rutgers University recently reviewed the research on employee ownership and concluded, “25 years of research shows that employee ownership often leads to higher-performing workplaces and better compensation and work lives for employees.”[1]

Much of the research on employee-owned businesses has focused on employee stock ownership plans (ESOPs) since the large majority of employee-owned businesses are ESOP companies. ESOPs are defined-contribution retirement plans that buy and hold stock in the company where the employee works. While ESOPs confer ownership rights to employees, they do not necessarily give the employees any control over their workplace. Most companies with ESOPs do not confer voting rights to the employees to elect the board of directors. There are about 10,000 ESOP companies covering approximately 10% of the American workforce. However, employees own a majority of the companies’ shares in only about 1,500 of them. In that group, only a small percentage give the employees democratic control.

By contrast, employee-owners of worker cooperatives adhere to the cooperative principles of democratic ownership and control. Employees are members of the co-op, own shares of the business and elect a governing board according to one member, one vote. In some smaller worker cooperatives, every member participates on the governing board.

TeamX

An excellent example of how worker cooperatives can meet the needs of workers seeking to fashion their own destiny is teamX of Los Angeles, California. A socially responsible investor—Ben Cohen and his Hot Fudge Venture Fund—was determined to show that a clothing manufacturer did not need to operate under sweatshop conditions (including low wages) in order to make a profit. The result was teamX, inc., a worker-owned, casual apparel manufacturing business that stitched its first shirt in March 2002. The co-op pays production workers hourly wages well above prevailing industry levels and benefits that some employees never had before. TeamX boasts that its sweatX brand is the only brand that can provide a 100 percent guarantee that workers are paid a livable wage, receive benefits, and work under good conditions. As of July 2002, the co-op employed 35 production workers and 6 managers.

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[1] Kruse, Douglas, “Research Evidence on the Prevalence and Effects of Employee Ownership,” *Journal of Employee Ownership Law and Finance*, Vol. 14, No. 4, Fall 2002, Oakland: National Center for Employee Ownership, p. 77.

Organizers of the teamX business were inspired by the success of Mondragon Corporacion Cooperativa in the Basque region of Spain. Mondragon is a massive network of worker-owned cooperatives that has grown into a global industrial powerhouse. The teamX founders wanted to ensure that the workers would always be in control and the Mondragon example demonstrated that this could be done while the business remains profitable.

Cooperative Home Care Associates

Headquartered in the South Bronx in New York City, Cooperative Home Care Associates is a worker-owned home health care agency that employs more than 550 African American and Latina women – 74% of whom had previously been dependent on public assistance. When the co-op was founded in 1985, Medicare policy was forcing many patients out of hospital beds and back into their homes. At the same time, the home health aides expected to care for these clients were being offered extremely poor jobs with little training, low wages, no benefits and temporary work. The business was organized to provide higher quality jobs to the home health aides and, thus, a higher quality of care to patients.

Today, wages for co-op members average $8 an hour, among the industry's highest, particularly in New York. Benefits for co-op members include individual health insurance, paid vacation, and sick time – also among the best in the industry. Worker turnover is less than 20% a year, compared to an industry average of 40-60%. As a cooperative, 80% of the employees share in the ownership of the business and elect the board of directors from among their own ranks.

Barriers to Start-Up and Expansion

A primary barrier to groups seeking to form a worker cooperative is equity capital. The start-up capital it takes to get a business off the ground is daunting for anyone, but it is unusually difficult for cooperatives because they typically must generate capital from within their membership. Outside investors are often loath to invest in a business that they are not allowed to control. But generating capital is even more difficult for worker-owned cooperatives because, in many cases, the members of those co-ops have limited economic means to buy the business from their current employer or to start a new business. The only way that cooperatives like teamX and Cooperative Home Care Associates were able to get started was with sizable infusions of investment from social entrepreneurs and socially responsible investors.

Another barrier is a bias against cooperatives in the programs of the Small Business Administration. The SBA specifically prohibits lending to cooperatives. SBA loan guarantees, supporting very high loan to value ratios, are not available to worker cooperatives.

Yet another barrier to worker cooperatives is the lack of technical assistance. While some states have been proactive in helping set up institutions to support employee ownership (e.g. the Ohio Employee Ownership Center and the Vermont Employee Ownership Center), the vast majority have not. There are also some excellent private technical assistance providers, including the ICA Group and the Southern Appalachian Center for Cooperative Ownership also represented by witnesses on this panel. In most areas of the country, however, few are knowledgeable about and are able to assist in the formation of worker cooperatives.

And finally, another barrier is the lack of understanding among the small business community about worker-owned cooperatives. The same section of the tax code—Section 1042—that provides significant tax advantages to business sellers who convert their companies to ESOPs also applies to company owners that sell to their employees as a worker-owned cooperative. Section 1042 allows business sellers to defer taxes on capital gains realized by the sale of their business to their employees in either form.

Though Section 1042 gave rise to the birth of thousands of ESOPs, the law has been rarely if ever used by small business owners to convert their companies to worker-owned cooperatives. For many small businesses—those with just a few employees—an ESOP is often not a viable option; it is too costly. Yet few small business owners, looking to exit their industry or retire, are even aware that they can sell their business to their employees as a co-op and defer capital gains. Those that are aware of worker cooperatives often have misperceptions about them. But selling their business to a worker cooperative can provide new and valuable succession planning options for the small business community.

There will be substantial economic gains for both business sellers and buyers if more small businesses took advantage of Section 1042's application to worker cooperatives.

Policy Supporting Worker Cooperative Development

NCBA believes it is sound federal policy to encourage the development of more worker-owned cooperatives in both urban and rural areas. Doing so will not only generate new wealth and ownership opportunities in some of our nation's most economically distressed communities, it will benefit the small business sector by retaining jobs and productivity in business that might have otherwise shut its doors after owners retired. The proven business performance results of employee-owned businesses also demonstrate that the growth and expansion of these businesses is good for the American economy.

While new legislation to create new financial tools for worker-owned cooperatives is needed, it is also important that existing federal economic development programs explicitly include development of worker owned cooperatives as eligible projects.

The legislation proposed by Congressman Sanders to create a U.S. Employee Ownership Bank is a welcome step in the right direction to address these barriers. While subordinated loans, loan guarantees and technical assistance offered by the proposed Bank are appropriate functions, we would also recommend tackling the issue of equity capital for workers starting up cooperatives. This is no easy task and would certainly require a substantial investment, but the payoff would likewise be substantial.

The legislative proposal should also eliminate the SBA prohibition on lending to cooperatives and even mandate that SBA offer its services to employee-owned businesses. In addition, SBA staff will need training and education in the structure, operation and value of employee-owned businesses, and in particular, cooperatives.

While technical assistance is extremely important, it is questionable whether most state governments would be able to make good use of the grant funding the proposed Bank would distribute to support education and outreach, technical assistance, and training. Few states have the expertise on the worker-cooperative business form. We would recommend that the Bank make these grants to non-profit and cooperative organizations with experience in developing employee-owned businesses and worker-owned cooperatives. Organizations such as the Vermont Employee Ownership Center, the Ohio Employee Ownership Center, the CooperationWorks network of 17 cooperative development centers, the ICA Group, the Southern Appalachian Center for Cooperative Ownership, and many Universities do have sufficient expertise to provide the education and outreach that the proposed legislation envisions.

While states have little expertise with worker-owned cooperatives, they do have tremendous experience with small businesses. In this regard, states could be helpful in working to educate the small business community about the succession planning option of converting their businesses to worker-owned cooperatives by selling to their employees under the provisions of Section 1042. Rather than providing states with a primary role in education and training about worker cooperatives and other forms of employee owned businesses, the legislation could provide States with grants to conduct outreach to small business owners to educate them about Section 1042 and the options it provides them.

NCBA urges the committee to carefully define what a worker cooperative is. To truly be a cooperative, the members must own and govern the business and control a majority of the seats on the board. While outside investors, or the sellers of a business may retain a financial stake in the business, they workers must control the business. If they don't, it's not a cooperative.

We would also suggest that the Bank would benefit from ongoing counsel from the employee ownership and worker cooperative business communities. We recommend that any legislation providing the federal government with new functions to promote and support worker-owned cooperatives include the formation of an advisory council made up of representatives of the worker-owned co-op and ESOP community that would guide and support the work of the Bank.

Thank you, again Mr. Chairman and members of this Committee for this opportunity to testify.

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